Internal Revenue Service

memorandum

CC:INTL-0328-91
Br1:WEWilliams

date:

to: Chief, Examination Division
Attn: Ms. Stacy Bosch
St. Paul District

from: Chief, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

subject: Deductibility of Taxes Paid to Virgin Islands
Taxpayers: [redacted]

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYERS INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT FOR USE IN THEIR OWN CASES.

This responds to your memorandum dated April 11, 1991, in which you request our views on whether taxpayers may deduct certain income taxes paid to the U.S. Virgin Islands on their federal Individual Income Tax Returns, Forms 1040.

Background:

As we understand the facts, [redacted] (taxpayers) are U.S. citizens who resided in the U.S. through [redacted]. In that year, they sold [redacted] shares of stock in [redacted] for a sale price of at least $[redacted]; taxpayers received none of the sale price in [redacted].

In [redacted], taxpayers became inhabitants of the Virgin Islands and changed their accounting method from the cash to the accrual basis. Taxpayers received $[redacted] of the sale price in [redacted]. Taking the position that they were inhabitants of the Virgin Islands and entitled to satisfy their federal tax liabilities by filing a return with the Bureau of Internal Revenue of the Virgin Islands (BIR), taxpayers filed a Form 1040 with the BIR. On the theory that as accrual basis taxpayers, the sale of the property occurred in [redacted] and that

all income from the sale was reportable on the [redacted] return, taxpayers reported none of the gain from the sale on their [redacted] V.I. income tax return.[1]/

The BIR determined that taxpayers had unreported income in [redacted] from the sale of stock in the amount of $[redacted] and issued a statutory notice of deficiency on [redacted], for a tax deficiency of $[redacted], plus penalties under I.R.C. §§ 6653(a)(1)(A), 6653(a)(1)(B), and 6661, plus interest.[2]/ On [redacted], taxpayers' representative had a district conference with a representative of the BIR. As a result of this conference, the BIR agreed to reduce the tax deficiency by just over $[redacted], if taxpayers provided certain documentation concerning their basis in the shares of stock.

The tax deficiencies, penalties, and interest were apparently assessed subsequent to the district conference with the BIR. The BIR is sending us additional information which we will forward to you as soon as we receive it. We are attaching copies of Payment Posting Vouchers indicating that taxpayers made advance payments on [redacted], [redacted], and [redacted], in the respective amounts of $[redacted] (designating $[redacted] of the payment as interest), $[redacted], and $[redacted] (designating $[redacted] as interest).

In [redacted], taxpayers moved back to the U.S. and again began filing federal income tax returns with the IRS. On their [redacted] joint income tax return, taxpayers deducted the tax and interest paid to the V.I. during [redacted] on the deficiency for [redacted].

Discussion:

It is our view that the amounts paid to the V.I. in [redacted] and [redacted], representing payments on the deficiency for [redacted], may not be deducted on taxpayers' federal income tax returns. The basis for this conclusion is that the taxes owed to the V.I. are a federal liability the collection of which Congress has ceded to the V.I. These taxes are not a state or local

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[1]/ Rev. Rul. 82-179, 1982-2 C.B. 87, describes this precise situation and concludes that such a change of accounting method requires pre-approval from the Director, Bureau of Internal Revenue of the Virgin Islands.

[2]/ The BIR statutory notice of deficiency was mailed to taxpayers at [redacted], [redacted], [redacted] [redacted].

tax deductible under section 164(a).[3]/ I.R.C. § 275 provides as follows:

> (a) GENERAL RULE.--No deduction shall be allowed for the following taxes:
>
> (1) Federal income taxes ....

The authority for our view that the taxes paid by taxpayers to the V.I. is a federal liability is as follows. The V.I. is a territory of the U.S., and in the Naval Appropriations Act of 1921, ch. 44, § 1, 42 Stat. 123, the U.S. Congress made the tax laws of the U.S. the local tax laws of the V.I. Under the mirror system, the words "Virgin Islands" are substituted for the words "United States" in the Internal Revenue Code as applicable in the V.I. Thus, prior to 1954, a U.S. citizen who was an inhabitant of the V.I. filed two income tax returns - one with the V.I., because he was a resident of the V.I., reporting worldwide income; and a second with the U.S. reporting worldwide income (including V.I. source income). Double taxation was prevented by the V.I. allowing a credit against V.I. tax for the tax paid to the U.S. on non-V.I. source income and by the U.S. allowing a credit against federal tax for the tax paid to the V.I. on V.I. source income. See Chicago Bridge & Iron Co. v. Wheatley, 430 F.2d 973, 974 & n. 1 (3d Cir. 1970). In explaining the pre-1954 system, as it applied to U.S. corporations (i.e., foreign corporations for purposes of the mirror Code), the Third Circuit in Chicago Bridge observed, at page 974, that

> [t]he Virgin Islands has jurisdiction to tax corporations of mainland domicile on income from sources within the Virgin Islands. At the same time the United States has jurisdiction to tax the income of such corporations regardless of source, and does so.[4/]

In 1954, in the Revised Organic Act of the V.I., ch. 558, § 28(a), 69 Stat. 508, Congress provided that inhabitants of

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[3]/ "State or local taxes" is defined in section 164(b)(2) as including a tax imposed by a U.S. possession.

[4]/ See Danbury, Inc. v. Olive, 820 F.2d 618, 621 (3d Cir. 1987), rev'g 627 F.Supp. 513 (D. V.I. 1986), cert. denied 108 S. Ct. 453 (1987), in which the court observed that "[t]he mirror system, with its two separate taxing jurisdictions, operated similarly for citizens of the United States ...."

the V.I. "shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands .... [Emphasis added.]" This provision applied to individual as well as corporate taxpayers. Through this provision, Congress ceded to the V.I. the U.S.'s authority to collect tax on non-V.I. (including U.S. source) income of a U.S. citizen inhabitant of the V.I. The tax, collection of which was ceded to the V.I., is not the liability imposed by the mirrored Code (the local tax law of the V.I.); the liability ceded to the V.I. is the liability that the U.S. citizen inhabitant of the V.I. would otherwise owe to the U.S. on non-V.I. source income.[5]/

In the case of a U.S. citizen who was a bona fide inhabitant of the V.I., section 28(a) of the Revised Organic Act eliminated the requirement of filing a U.S. federal income tax return to the extent that the individual filed a V.I. income tax return reporting and paying V.I. tax on his worldwide income. It was the long-standing position of the IRS and of the BIR that section 28(a) did not affect the total liability of a U.S. citizen or corporate inhabitant of the V.I., and this position was upheld by the Third Circuit in Danbury, Inc., supra.

Clearly, section 28(a) of the Revised Organic Act in no way changed the substantive tax law of the V.I. or that of the U.S.; section 28(a) is exclusively a collection statute. As observed by the Third Circuit in Danbury, Inc., supra, at page 623, "[s]ection 28(a) is not a taxing provision...." In this regard, the Third Circuit in Danbury, Inc., at page 623, stated that

> looking at the applicable law prior to the Tax Reform Act [of 1986], Danbury owed the BIR (1) Virgin Islands taxes on Virgin Islands-generated income, under the Naval Appropriations Act [i.e., the mirrored Code], and (2) U.S. taxes on worldwide income, figured with a tax credit for any Virgin Islands or other foreign taxes paid, under Section 28(a). [Emphasis added.]

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[5]/ Although not an issue here, it is our position that to the extent the federal liability is not paid to the V.I., there is a residual liability to the U.S. which the IRS could collect on the V.I.'s behalf. The Tax Reform Act of 1986, P.L. 99-514, enacted this residual liability into the statute in I.R.C. § 932(c)(4).

And, at page 624:

> the language of Section 28(a) clearly states that inhabitants of the Virgin Islands must pay their U.S. income taxes directly to the BIR. [Emphasis added.]

In the case of a U.S. citizen who was an inhabitant of the V.I., the IRS has also recognized that the federal tax liability of such person, prior to the effective date of the 1986 Reform Act, was satisfied by filing a single return with the V.I. reporting and paying tax under the mirrored and non-mirrored Codes on worldwide income. Rev. Rul. 60-291, 1960-2 C.B. 407, states in pertinent part that

> after July 22, 1954 [the effective date of section 28(a)], United States citizens domiciled in the Virgin Islands who qualify as inhabitants of the Virgin Islands, as defined in section 28(a) of the Revised Organic Act of the Virgin Islands, are required to satisfy their income tax obligations under the applicable taxing statutes of the United States by filing their returns with the taxing authorities of the Virgin Islands and paying into the treasury of the Virgin Islands their tax on income derived from all sources, both within and without the Virgin Islands. [Emphasis added.]

The authority seems clear that under the section 28(a) inhabitant rule, the tax that must be reported and paid to the V.I. is the exact same tax that would have been reported, if the inhabitant rule had not been enacted, on the taxpayer's V.I. and U.S. income tax returns.

If the inhabitant rule had not been in effect in [redacted], the year in issue, [redacted], as residents of the V.I., would have filed a V.I. return reporting worldwide income (including gain attributable to the payment of $[redacted] from a U.S. source) and paid tax under the mirror Code. Taxpayers would also have filed a U.S. return, as U.S. citizens, reporting worldwide income and paying tax under the Internal Revenue Code. Double tax would have been prevented by the V.I. allowing a credit for the tax paid to the U.S. on non-V.I. source income and by the U.S. allowing a credit for the tax paid to the V.I. on V.I. source income. Under the inhabitant rule, the U.S. ceded collection of the federal

liability (i.e., tax on worldwide income less V.I. source income) to the V.I. This is precisely the tax liability that was assessed by the V.I. in this case for [redacted].[6]

Because the tax paid by taxpayers to the V.I. was a federal income tax liability collectible by the V.I. under the inhabitant rule, we think that section 275 bars a deduction of the tax on taxpayers federal returns for the years in which the tax was paid.

As to the portion of the payments to the V.I. that is deficiency interest for tax year [redacted], the Tax Reform Act of 1986, § 511(b), P.L. 99-514, effective for tax years beginning after December 31, 1986, enacted new section 163(h). Section 163(h)(1) provides that "[i]n the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year." "Personal interest" is defined in section 163(h)(2) as any interest that is deductible under chapter 1B of the Code, except for five enumerated categories. The Conference Committee Report on this amendment states that "[p]ersonal interest also generally includes interest on tax deficiencies." H.R. Rep. No. 99-841, 99th Cong., 2d Sess. II-154 (Sept. 18, 1986), 1986-3 C.B. Vol. 4, 154. However, we note that there is a phase-in of the disallowance of deductions for personal interest for taxable years 1987 through 1990. See I.R.C. § 163(h)(5).

Conclusions:

We recommend that you strongly resist taxpayers' attempt to deduct payments of federal tax liability on their federal returns. Allowance of such deduction is barred by section 275. The interest paid by taxpayers on this liability is deductible only to the extent permitted by section 163(h).

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[6]/ Our conclusions would be the same if the tax year in issue was not [redacted] but rather a year beginning after [redacted], and therefore, covered by the amendments to section 932 by the Tax Reform Act of 1986.

If you have any questions or if we can be of further assistance in this matter, please call Ed Williams at FTS 287-4851.

GEORGE M. SELLINGER

Attachments:
Copy of V.I. statutory notice
Copy of V.I. District Conference Statement
Copies of V.I. Posting Vouchers